

Internal Revenue Service

Department of the Treasury
Washington, DC 20224

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Date:
November 04, 2010

X =

State 1 =

State 2 =

Date 1 =

Date 2 =

Year 1 =

Year 2 =

Year 3 =

Dear :

We received your letter dated June 8, 2010, and subsequent correspondence, written on behalf of X, requesting a ruling under § 1362(f) of the Internal Revenue Code (Code). This letter responds to your request.

FACTS

X was incorporated under the laws of State 1 on Date 1. X elected to be an S corporation effective Date 2. Beginning in Year 1, X remitted a State 2 tax on behalf of

its shareholders who were not residents of State 2. While X did provide each of its shareholders who were not residents of State 2 with the amount of State 2 tax X paid on their behalf, X did not treat those payments as constructive distributions to such shareholders. X represents the State 2 tax payments it made from Year 1 through Year 2 should have been treated as constructive distributions, which caused the distributions X made to its shareholders to be disproportionate from Year 1 through Year 2.

X represents it was not aware that its failure to treat the State 2 tax payments as constructive distributions could cause X to be treated as having more than one class of stock. Likewise, X represents that it did not intend to terminate its S corporation election and that the circumstances resulting in the possible termination of the election were not motivated by tax avoidance or retroactive tax planning. X represents it has taken or will take the following corrective actions: (1) in late Year 2, X made remedial distributions to correct the effect of the potential disproportionate distributions X may have made; (2) for Year 3 and subsequent years, X will treat the State 2 tax it pays on behalf of its shareholders who are not residents of State 2 as constructive distributions and will take into account such constructive distributions when making distributions to its shareholders, so that each outstanding share of its stock will confer identical rights to distributions. X represents that X and each of its shareholders have filed all returns consistent with X's S corporation election from Year 1 through the present.

LAW AND ANALYSIS

Section 1361(a) provides that the term "S corporation" means, with respect to any taxable year, a small business corporation for which an election under § 1362(a) is in effect for such year.

Section 1361(b)(1)(D) provides that, for purposes of subchapter S, the term "small business corporation" means a domestic corporation which is not an ineligible corporation and which does not, among other things, have more than one class of stock.

Section 1.1361-1(l)(1) of the Income Tax Regulations provides, in part, that a corporation that has more than one class of stock does not qualify as a small business corporation. Except as provided in § 1.1361-1(l)(4) (relating to instruments, obligations, or arrangements treated as a second class of stock), a corporation is treated as having only one class of stock if all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds. Differences in voting rights among shares of stock of a corporation are disregarded in determining whether a corporation has more than one class of stock.

Section 1.1361-1(l)(2)(i) provides, in part, that the determination of whether all outstanding shares of stock confer identical rights to distribution and liquidation proceeds is made based on the corporate charter, articles of incorporation, bylaws, applicable state law, and binding agreements relating to distribution and liquidation

proceeds (collectively, the governing provisions). Although a corporation is not treated as having more than one class of stock so long as the governing provisions provide for identical distribution and liquidation rights, any distributions (including actual, constructive, or deemed distributions) that differ in timing or amount are to be given appropriate tax effect in accordance with the facts and circumstances.

Section 1.1361-1(l)(2)(ii) provides that state laws may require a corporation to pay or withhold state income taxes on behalf of some or all of the corporation's shareholders. Such laws are disregarded in determining whether all outstanding shares of stock of the corporation confer identical rights to distribution and liquidation proceeds, within the meaning of § 1.1361-1(l)(1), provided that, when the constructive distributions resulting from the payment or withholding of taxes by the corporation are taken into account, the outstanding shares confer identical rights to distribution and liquidation proceeds. A difference in timing between the constructive distributions and the actual distributions to the other shareholders does not cause the corporation to be treated as having more than one class of stock.

Except as provided in § 1362(g), § 1362(a)(1) provides that a small business corporation may elect, in accordance with the provisions of § 1362, to be an S corporation.

Section 1362(d)(2)(A) provides that an election under § 1362(a) shall be terminated whenever (at any time on or after the first day of the first taxable year for which the corporation is an S corporation) such corporation ceases to be a small business corporation.

Section 1362(f) provides, in part, that if (1) an election under § 1362(a) by any corporation was terminated under § 1362(d)(2) or (3); (2) the Secretary determines that the circumstances resulting in the termination were inadvertent; (3) no later than a reasonable period of time after discovery of the circumstances resulting in the termination, steps were taken so that the corporation is a small business corporation; and (4) the corporation, and each person who was a shareholder of the corporation at any time during the period specified pursuant to § 1362(f), agrees to make the adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period, then, notwithstanding the circumstances resulting in the termination, the corporation shall be treated as an S corporation during the period specified by the Secretary.

CONCLUSION

Based on the information submitted and representations made, we conclude that if X had more than one class of stock, X's election to be treated as an S corporation terminated in Year 1 when X first made the State 2 tax payments on behalf of its shareholders who were not State 2 residents. However, we conclude that, if X's S corporation election was terminated, such termination was inadvertent within the

meaning of § 1362(f). Therefore, X will be treated as continuing to be an S corporation from Year 1 and thereafter, provided X's S corporation election was valid and was not otherwise terminated under § 1362(d). For all relevant years, X's shareholders must include their pro rata share of the separately stated and nonseparately computed items of income or loss of X as provided in § 1366, make any adjustments to basis as provided in § 1367, and take into account any distributions made by X as provided in § 1368.

Except as expressly provided herein, we express or imply no opinion concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. Specifically, we express or imply no opinion concerning whether X is otherwise eligible to be treated as an S corporation for federal tax purposes.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

In accordance with a power of attorney on file with this office, we are sending a copy of this letter to your authorized representative.

Sincerely,

/s/

Mary Beth Carchia
Senior Technician Reviewer, Branch 3
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures (2)

Copy of this letter

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